No. 84-852

Office-Supreme Court, U.S.
FILED
FEB 14 1985
ALEXANDER L. STEVAS,

In the Supreme Court of the United States

OCTOBER TERM, 1984

ERNST & WHINNEY, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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TABLE OF AUTHORITIES

Page

Case:

Miree v. *DeKalb County*, 433 U.S. 25 2

Statutes and rule:

Internal Revenue Code of 1954 (26 U.S.C.):

§ 38 2

§§ 46-48 2

§ 48(a)(1) 2

§ 48(a)(1)(B) 2

§ 6694 7

§ 6695 7

§ 7402(a) 1, 6, 7, 8, 9

§ 7407 ..... 5, 6, 7, 9

§ 7407(b)(1)(A) 7

§ 7407(b)(1)(D) 7

§ 7407(c) 6, 7

§ 7701(a)(36) 5

Fed. R. Civ. P. 12(b)(6) 1, 6

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Petitioners challenge the court of appeals' holding that an accounting firm alleged to be promoting a deceptive tax-reduction scheme and to be obstructing IRS investigations of the firm's clients may be enjoined (assuming the government's allegations are established to be true) from engaging in such conduct under Section 7402(a) of the Internal Revenue Code, which empowers the district courts to issue "writs and orders of injunction" where "necessary or appropriate for the enforcement of the internal revenue laws."

1. The facts, as alleged in the government's complaint and in its supporting affidavits,[1] may be summarized as

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[1]The district court granted petitioners' motion to dimiss the government's complaint under Fed. R. Civ. P. 12(b)(6) for failure to state a claim upon which relief could be granted. For purposes of appeal, therefore, the well-pleaded allegations of the complaint and the facts set

follows. Petitioner Ernst & Whinney is one of the "Big Eight" accounting firms. It has more than 100 offices located throughout the United States. The individual petitioners, all accountants, are present or former partners or employees of Ernst & Whinney's Atlanta Office (R. 6-8).[2]

In 1977 petitioners began to advertise and market a service known as the "Investment Tax Credit Study." The Study is designed to enhance the ability of clients (or prospective clients) to claim investment tax credits (ITCs) under Sections 38 and 46-48 of the Internal Revenue Code.[3] Those Sections permit a taxpayer to credit against its federal income tax liability a percentage (generally 10%) of the cost of "qualifying property." The principal types of "qualifying property" are machinery, equipment, and other sorts of tangible personal property used in a manufacturing or similar business (I.R.C. § 48(a)(1)). Buildings and their structural components do not qualify for the investment tax credit (I.R.C. § 48(a)(1)(B)).

The stated purpose of petitioners' ITC Study, as set forth in their promotional literature, is to identify items that are "traditionally considered a part of a building," but which in petitioners' view are eligible for the ITC as qualifying personal property (R. 8-9; Complaint, Exh. 1 to Affidavit A at 5). Petitioners in their Study propose to identify "all direct and indirect costs relating to" such allegedly qualifying items and, by the use of what petitioners describe as "correct and specific titles, terms and asset classifications," to help

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forth in the government's supporting affidavits must be accepted as true, together with all inferences that may reasonably be drawn in the government's favor. Pet. App. 2a, 26a. See *Miree* v. *DeKalb County*, 433 U.S. 25, 27 n.2 (1977).

[2]"R." refers to the Record Excerpt in the court of appeals.

[3]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

clients prevent the loss of ITCs through "misidentification" of such property (*ibid.*). In marketing their Study, petitioners make representations to taxpayers who own (or who plan to construct or acquire) buildings about tax savings potentially achievable through expanded use of the credit (Pet. App. 3a). If the taxpayer chooses to enlist their services, petitioners identify building components supposedly eligible for ITCs, obtain cost information about those items, and prepare a final report which describes the allegedly qualifying property in carefully phrased and "specific" terms. *Ibid.*

The actual purpose of petitioners' ITC Study, according to the government's complaint, is to advise taxpayers improperly to claim ITCs on nonqualifying property and to help taxpayers prevent the IRS from detecting those improper claims. To that end, it is alleged that petitioners systematically develop misleading and deceptive terminology for buildings and their structural components in order to make such property sound like "qualifying property" on the taxpayer's books and records. For example, petitioners in their ITC Studies allegedly have referred to concrete block walls as "knock-out panels"; to ordinary doors as "movable partitions — wood"; to fixed drywall interior walls as "movable partitions — gypsum"; to a section of a roof as an "equipment support"; to a building entrance canopy constructed of heavy timbers as "trellis work"; and to a shrubbery area constructed of brick and masonry as an "interior portable planter" (Pet. App. 3a n.1; R. 11-16). By using such terminology, it is alleged, petitioners hope that IRS agents examining the taxpayer's books and records will be misled into thinking that such clearly ineligible items qualify for the credit.

Similarly, petitioners are alleged to have developed misleading and deceptive terminology for property of questionable ITC eligibility in the hope that IRS examiners will

be unable to identify such items as potentially subject to challenge. For example, petitioners allegedly have referred to ordinary electric lighting fixtures in a building as "accent" or "decorative" lighting; to portions of streets and parking lots as "transportation and equipment accessways" and "truck accessways"; to shopping mall signs as "identifying devices"; to fixed industrial heating units as "portable plug-in" or "unit" heaters; and to dropped ceilings as "decorative soffits" (R. 11-16).

In furtherance of this tax-reduction scheme, petitioners are alleged to have taken other steps to frustrate IRS efforts to detect clients' improper ITC claims. The government's complaint alleges, for example, that petitioners have failed to maintain, or to provide to their clients, documentation sufficient to identify the specific cost components of assertedly qualifying property. Thus, even where IRS agents have succeeded in identifying improper ITC claims, it has allegedly been extremely difficult for the taxpayer or the IRS to reconstruct the property's correct cost basis (R. 16). Petitioners are also alleged to have created false or misleading documentation to support clients' ITC claims (R. 28-29), such as suggesting changes in an architect's terminology so that his records appear to supply independent proof of assertions (for example) that certain walls were intended to be movable (see Plaintiff's Memorandum in Support of Its Motion for Partial Summary Judgment 57-60).

The cumulative effect of petitioners' practices, according to the government's complaint, is to overburden the IRS's limited audit resources, to encourage taxpayers to claim ITCs on virtually every part of a building and its structural components except for the naked load-bearing shell, and to ensure that a significant percentage of such improper or questionable claims will go undetected and unchallenged by the IRS. Petitioners' ITC Studies appear to have been marketed nationally and to have been used by hundreds or

thousands of taxpayers, resulting in what the government believes may be enormous losses of revenue.[4] Petitioners' practices are thus alleged to hinder, obstruct and interfere with the government's ability properly to administer the internal revenue laws (R. 22-24).

2. The United States brought this action seeking to enjoin petitioners from "[a]dvertising, marketing, [or] selling" their ITC Studies, from advising the use by clients of "misleading, deceptive or false terminology" designed to prevent discovery of questionable or improper ITC claims on audit, and from "[h]indering, obstructing and impeding" the IRS in its investigation of petitioners' customers (Pet. App. 3a; R. 28-29).[5] Insofar as petitioners were functioning in connection with the Studies as "income tax return preparers" as defined in Code Section 7701(a)(36),[6] the government based its request for an injunction on Code Section 7407, which provides for the issuance of injunctions

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[4]In eight completed audits of taxpayers that used petitioners' ITC Studies in Ernst & Whinney's Southeastern Region — the region in which the firm's Atlanta office is located — there have been adjustments in excess of $3 million to the cost basis of property claimed to be eligible for the ITC, with a resulting tax increase of more than $300,000 (R. 22; Plaintiff's Supplemental Affidavit A at 1-2).

[5]Petitioners err in describing the relief sought in the complaint as an injunction barring them "from providing specified tax advisory services to their clients" (Pet. 1-2, 4). As explained the text, the complaint sought to enjoin petitioners, not from providing tax advice, but from "marketing" the ITC Studies and from using intentionally misleading terminology in providing tax advice.

[6]That Section generally defines an "income tax return preparer" as a person who prepares for compensation all or a substantial portion of any income tax return or claim for refund. Petitioners have taken the position that in most instances involving the ITC Studies they do not qualify as income tax return preparers. See Complaint, Exh. 1 to Affidavit C at 13. Whether petitioners were acting as return preparers is a factual determination that has not yet been made by the district court (Pet. App. 4a n.3).

against return preparers under specified conditions. Insofar as petitioners were not functioning as return preparers, the government based its request for an injunction on Code Section 7402(a), which empowers the district courts to issue "writs and orders of injunction * * * as may be necessary or appropriate for the enforcement of the internal revenue laws." After the complaint was filed, petitioners posted surety bonds under Code Section 7407(c) (Pet. App. 5a, 27a & n.2). That Section permits a return preparer to stay government actions to enjoin certain types of return-preparer misconduct by filing a $50,000 bond "as surety for the payment of [specified] penalties."

The district court granted petitioners' motion to dismiss the government's complaint for failure to state a claim upon which relief could be granted (Pet. App. 37a). The court ruled that petitioners' conduct could not be enjoined under Section 7407, reasoning that their posting of a bond precluded an injunction against them insofar as they were "return preparers" (Pet. App. 27a-32a). And the court held that petitioners' conduct (whether or not it constituted "return preparation") could not be enjoined under Section 7402(a) either, reasoning that that Section does not by itself authorize the issuance of injunctions, but rather applies only when the government seeks to enforce some "underlying Code section" which "directly create[s] some duty on the part of the defendant sought to be enjoined" (Pet. App. 37a). The district court concluded that the government was "unable to point to any provision of the Code" which imposed on petitioners a duty to refrain from the misleading, deceptive, and harassing conduct they were alleged to have engaged in (*ibid.*). Accordingly, the court held that it was without power to issue the requested injunction and granted petitioners' motion to dismiss under Fed. R. Civ. P. 12(b)(6) (Pet. App. 38a-39a).

3. The court of appeals unanimously reversed (Pet. App. 1a-20a). It held that either Section 7407 or Section 7402(a) could support issuance of an injunction, depending on what facts the IRS was able to prove on remand (Pet. App. 20a). The court of appeals accordingly remanded for investigation of the government's factual allegations and for consideration of the equitable factors that might bear upon the district court's exercise of its discretion to grant the requested relief (*ibid.*).

As to Section 7407, the court of appeals observed that the $50,000 bond posted by petitioners barred an injunction only to the extent that the conduct sought to be enjoined was conduct described in Section 7407(b)(1)(A) (Pet. App. 12a-13a, citing I.R.C. § 7407(c)). Section 7407(b)(1)(A) authorizes injunctions against "conduct subject to penalty under section 6694 or 6695, or subject to any criminal penalty."[7] The court concluded that, although much of petitioners' alleged misconduct did fall under Section 7407(b)(1)(A), their allegedly aggressive promoting and marketing of the ITC Study did not fall under that Section, but rather fell under Section 7407(b)(1)(D). That latter Section authorizes injunctions against any "fraudulent or deceptive conduct" of a return preparer "which substantially interferes with the proper administration of the Internal Revenue laws." To the extent that petitioners on remand are found to be functioning as "return preparers," therefore, the court of appeals held that their marketing activities could be enjoined under Section 7407(c) notwithstanding their posting of a bond — provided, of course, that

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[7]Sections 6694 and 6695 impose penalties on return preparers who negligently or willfully understate a taxpayer's tax liability, or who fail to take certain procederal steps, such as signing the taxpayer's return, supplying his identifying number, or furnishing the taxpayer with a completed copy of his return.

the government's allegations prove true and that "the showing required by § 7407 is made" (Pet. App. 20a).

The court of appeals also held that issuance of the requested injunction could be supported by Section 7402(a). That Section, the court observed, "encompasses a broad range of powers necessary to compel compliance with the tax laws" (Pet. App. 7a). Rejecting the district court's "narrow construction" of the Section, the court of appeals followed numerous decisions from other circuits that have authorized use of Section 7402(a) "to enjoin interference with tax enforcement even when such interference does not violate any particular tax statute" (Pet. App. 7a (citing cases)). The court accordingly held that, to the extent petitioners on remand are found to be acting in a capacity other than that of return preparers, the district court has the power to enjoin them under Section 7402(a) if the government can demonstrate that they are improperly interfering with enforcement of the tax laws (Pet. App. 7a-8a). The court of appeals therefore remanded the case to the district court, noting that numerous "factual disputes * * * must be resolved" and that "the decision to issue an injunction under § 7402(a) is governed by the traditional factors shaping the district court's use of the equitable remedy" (Pet. App. 8a-9a).

4. Petitioners reiterate their contention that Section 7402(a) does not authorize the issuance of an injunction in the absence of another Code section imposing substantive duties on the person sought to be enjoined. Whatever the merits of petitioners' contention, it is not now ripe for review by this Court.[8] The court of appeals' decision places

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[8]It is now nearly three years since the government's complaint was filed and more than two years since the district court's decision was entered. Further interlocutory review at this time would cause serious additional delay in the trial of the government's allegations against petitioners.

petitioners in precisely the same position they would have occupied had the district court in the first instance denied their motion to dismiss the complaint and proceeded to trial on the merits. If, as a result of the proceedings on remand, the government's request for an injunction is denied, petitioners' contentions will be moot. If, on the other hand, the government succeeds in establishing its allegations against petitioners, and if the courts below determine that an injunction is justified under Section 7402(a) or under Section 7407, petitioners will then be able to present their contentions to this Court, together with any other claims they may have, in a petition for a writ of certiorari seeking review of a final judgment against them. Accordingly, review of the court of appeals' decision would be premature at this time.[9]

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[9]Petitioners suggest (Pet. 9-10) that immediate review is appropriate, despite the interlocutory posture of the case, because "the issue is whether the matter should be determined in a court proceeding or [in an] administrative proceeding," a determination petitioners believe should be made now and "not after what could be years of litigation in a forum not intended by Congress." Similar arguments, of course, can usually be made by any petitioner who seeks certiorari while his case is in an interlocutory posture, and do not provide a reason for departing from this Court's normal practice of not undertaking piecemeal review of interlocutory orders. In any event, those arguments are particularly inapposite here. The court of appeals held that *either* Section 7407 *or* Section 7402(a) could authorize issuance of an injunction, and petitioners have sought review (Pet. i) of the latter holding only. Petitioners accordingly face a remand for trial on the merits of the government's allegations under Section 7407 in any event, and they are thus in no position to contend that the grant of interlocutory review would enable them to avoid an unnecessary trial.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.[10]

REX E. LEE
Solicitor General

FEBRUARY 1985

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[10]Because this case is in an interlocutory posture, we are not responding on the merits to the questions presented by the petition. We will do so if the Court requests.